

The PERAC Financial Bulletin



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**“This time it’s
different.”**

While skeptics certainly abounded, that was the mantra offered by many new age investors at the start of 2000. History be damned, there was no reason—given the irrelevancy of business cycles—why the economy wouldn’t have another year of robust growth, no reason why the stock market wouldn’t have yet another year of double-digit advance, no reason why fledgling internet companies with no earnings should not have market valuations higher than those of well-established consistently profitable “old economy” companies, and no reason why successful technology companies should not have valuations based on projected annual earnings growth rates of 40-50% as far as the eye could see.

During the first half of the year, the dot-com mania crashed and the technology stock bubble burst and, in the second half, slower economic growth caused a sharp decline in reported and projected corporate earnings. Investors realized that the market can be very cruel in reminding us that the fundamental rules have not changed and that the longer it takes for market extremes to run their course, the more

violent the correction. There is no question that the information technology revolution of the past decade is changing our lives in many fundamental ways, but—as seen in previous episodes of exciting industrial change—only a very few companies will emerge as long-term corporate winners.

After 2000’s topsy-turvy year, pension fund trustees no longer need to question why they own bonds, real estate, or even value stocks. They needn’t apologize for having a cash reserve. Momentum investing is dead. Fundamental analysis lives. Asset allocation rules!

Although it actually advanced 1.3% during the fourth quarter, the Dow Jones Industrial Average declined 6.2% in 2000, breaking a nine-year streak of positive returns and registering its worst performance since 1981. The S&P 500 was off 8.1% for the quarter and 10.1% for the year, its worst performance since 1977. It was the technology-laden NASDAQ Composite that led the year’s bloodletting; it was off 32.7% for the quarter and 39.3% for the year. In its worst performance since its creation in 1971, the NASDAQ took back most of its meteoric 1999 gain of 86%. From its peak in early March to its December trough, it declined 54%, wiping out \$3.3 trillion in paper wealth. Indeed, the NASDAQ’s decline in 2000 was the worst for any broad US market index since 1931.



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In the context of the overall market and its prior year gains, the year was not really that bad. The Dow and S&P gave back only about one sixth of what they made while tripling in value from 1995-99. (See accompanying charts.) The S&P actually had better breadth of stock participation last year than in 1999. In that year, more stocks actually declined than advanced although the overall

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index rose 19.5%. In 2000, more than half the stocks beginning the year in the S&P rose for the year. Without the tech component, the Index would have been up only 4% in 1999 and would have been down only modestly in 2000. If it had been equal-weighted rather than market-cap weighted, the S&P would have been up about 10% in 2000. About 30% of the S&P’s decline in 2000 was due to Microsoft; that company was the Index’s market cap leader at the beginning of 2000 but, after declining 63%, fell to sixth at year-end. Similarly, the Dow would have been up about 12% for the year if its two major technology components, Microsoft and

Intel, were excluded. It’s not easy to find any positives in the NASDAQ’s sorry performance, but, as seen in the graphs, its 2000 swoon puts its 2-year and long-term performance back in line with the S&P and the Dow.

The year saw extremes in both advancing and declining stocks. While many pure internet plays including CMGI and Priceline.com saw their stock prices decline by upwards of 95% and Amazon.com (still struggling for profitability) fell by 86%, even profitable internet portal Yahoo declined 86% and dominant player AOL fell 54%.

Reflecting problems in the telecom sector, AT&T fell by 66% while Lucent Technologies lost 81%. On the other hand, the market also saw some impressive winners, including Philip Morris, up 91%; Enron, up 87%; Boeing, up 59%; Pfizer, up 42%; and Merck, up 39%.

Further indicative of the market’s greater breadth, seven of the S&P’s eleven industrial sectors (led by utilities, up 55%; health care, up 35%; financials, up 25%; transportation, up 18%; and energy, up 13%) outperformed the overall index in 2000, compared to only four in 1999. With its 40% decline in 2000, the S&P’s technology sector declined from 34% of the overall index to 23% at year-end.

As the “old economy” came back into favor, value stocks trounced growth stocks in 2000, after six years of underperformance. As seen in the accompanying table, value components of the major indices all had positive returns for the year while their growth counterparts lagged by huge margins of 20-30%. As also seen in the table, small caps outperformed large caps while midcaps, reflecting their more attractive valuations than large caps and more stable franchises than small caps, outperformed everything.

As for the collapse of the technology bubble, it began in March when investors began to realize that having underestimated the Internet and related advances in the mid 1990s, it had vastly overestimated the medium’s potential to create profitable companies. While some success stories were to be found in Internet infrastructure stocks (i.e., Juniper Networks, up 145%, and Ciena, up 196%) at least 300 Internet stocks were off more than 90% for the year. If the concept of the new economy was perhaps not conclusively discredited, it was apparent that the new methods that analysts had developed in order to justify lofty stock valuations for companies with no immediate prospects for profitability had been totally misguided.

Besides questionable stock valuation practices, investors had clung to the proposition that technology companies were immune from the business cycle. Technology represented one quarter to one third of the nation’s economic growth in the second half of the 1990s and was clearly the main driver of the productivity boom that has kept inflation low. Over the past few months, however, personal computer sales have declined as corporate demand weakened following the Y2K buildup and the consumer market, where at least 60% of US households already have at least one PC, is also seeing slower growth. Corporations can proceed with their technological upgradings on a more orderly pace since they now see less of a threat from dot-com upstarts. Overall, there have been no exciting new products or dramatic price reductions of existing products to entice buyer interest. Computers are generally seen as a mature commodity, and there have been no major software products introduced that require greater hardware. New digital gadgetry is raising questions as to whether

the personal computer has peaked as the primary device for performing digital functions. There are also indications that growth in Internet usage may be leveling off; in any event, greater Internet usage might require more high speed data lines but, for the foreseeable future, not necessarily a new generation of computers.

Besides marking a shattering end to an historic bull market, this year's markets were characterized by gut-wrenching volatility, particularly in the NASDAQ. Indeed, NASDAQ had eight of its ten largest daily gains ever in 2000; in each case, however, these advances were followed by declines, usually to new lows.

The collapse of the NASDAQ in 2000 went hand-in-hand with the demise of the Initial Public Offering market. In contrast to when IPOs were seen as a ticket to instant wealth in past years, about two thirds of last year's IPOs ended the year below their offering price, with an average decline of 19%. About 12% of the issues were off at least 90% from their first day's close.

Meaningful industry-wide returns will not be available for a while, but the year's tech meltdown and closing of the IPO window are expected to have a dramatic dampening effect on venture capital returns for 2000. The number of venture-backed firms going public in the fourth quarter was only about one quarter the number during the third quarter. One thing we can expect is that the already traditionally very wide differential in returns between the best and worst performing venture partnerships will likely be even wider than in the past.

Although 2000 was a great year overall for proponents of asset allocation, investing in international stocks failed to provide any buffer against falling domestic stocks, as the MSCI EAFE Index declined 15% for the year and the MSCI Emerging Markets Index was off

30%. In most cases, foreign markets moved in sympathy to the US, with particular emphasis on the NASDAQ, but there were also specific factors and concerns such as the drastic fall of the Euro currency, disappointing political and economic trends in Japan, worries about poor corporate governance and stalled economic reforms in Asia, and the effect of the oil price rise in developing countries. In dollar terms, European markets held up better than Latin American markets while Asian/Pacific markets were off an average of 30%.

Bonds not only proved to be a good diversifying asset class versus stocks but US Treasuries enjoyed their best year since 1995 as a result of governmental buybacks, reduced issuance, and the effects of a slowing economy. Results were not uniform, however, as high-grade corporate securities underperformed as a result of heavy issuance and concerns over credit quality arising from the weakening economy. Mortgage-backed bonds lagged because lower mortgage rates increased the likelihood for prepayments of underlying mortgages. Buffeted by turmoil among telecom issuers and rising default rates, the high yield market suffered its worst year since 1990. In terms of actual rate levels, the Treasury's benchmark 10-year note declined in yield from 6.44% to 5.11% over the year while the 30-year bond declined in yield from 6.47% to 5.46%. (As explained in previous educational reports, the prices of existing bonds rise when prevailing interest rates decline.) Long-term A-rated industrial bonds yielded about 7.75% at year-end, having experienced only a modest decline during the year while rates on high-yield bonds rose drastically to a composite yield of about 13.75%.

Real estate dramatically confirmed its standing as one of the best diversifiers

relative to the stock market.

Demonstrating its very low correlation to equities, the private real estate market continued to deliver steady positive returns of 10-12% annualized. Publicly-traded Real Estate Investment Trusts, benefiting from investors taking advantage of low security valuations as they fled the shaky but still pricey stock market, delivered their best returns in four years, registering an average total return of 26%. While not immune to the potential effects of a recession, real estate is seen as currently enjoying a healthy equilibrium between supply and demand. In general, office developments have done the best, although vacancies caused by failing dot-coms are a factor in some markets. Retail has trailed other sectors, with the recent announced liquidation of two major chains demonstrating the perceived risks of overcapacity in this sector.

As 2001 begins, investors will be closely watching economic trends as well as developments in the markets. More than ever before, economic growth is directly affected by market trends, given US households' unprecedented holdings of stocks. The Federal Reserve demonstrated its concern over the economy's slowing by its dramatic, unexpected half point reduction in the federal funds rate on January 3, an action that spurred a furious but temporary market rally. However, investors hoping for a prolonged market recovery must cope with the reality that when bubbles burst, as did that of tech stocks last year, they often take years to recover. Just as markets overshoot on the upside, they can overshoot on the downside. Perhaps the most cautionary observation is that, even though they came down significantly from their earlier highs, valuations of tech stocks by traditional measures (i.e., price/earnings ratios) remain far from

cheap. Analysts see lingering overcapacity in areas such as telecom. Some strategists don't foresee a recovery by tech stocks until after there is a total "capitulation" by investors in this sector. On a more encouraging note, price/earnings valuations for the overall stock market have corrected to where they seem reasonable (although, particularly for large caps, still somewhat high) by historic standards and also, when considered inversely, fair relative to current yields on Treasury bonds.

After an extended period of above-trend equity returns, highlighted by one dominant sector that saw valuations reach irrational highs, investors were served a much-needed helping of reality in 2000 and it would not be surprising if returns remained modest in 2001 and perhaps for a few years to come. Markets can overshoot for extended periods, but they inevitably regress toward the mean, often overshooting it.

The year 2000 saw the decisive discrediting of trend-following momentum investing as one of history's largest financial bubbles violently burst. Now, investors will hopefully no longer shoot for the moon but will revert to traditional fundamental analysis in an effort to preserve and grow their assets. For pension trustees, the year 2000 was one where investment returns lagged behind increased pension liabilities by a record margin. Those pension fund fiduciaries who structured their portfolios according to diversified asset allocation weathered last year's storm as well as possible. Going forward, those funds that are well diversified not only among major asset classes but also among sub-classes should be in best position to cope with whatever surprises the markets of the new millennium might have in store. While we undoubtedly live in a time of exciting technological change,

we've learned—some more painfully than others—that, as far as the fundamental ways of analyzing and allocating investments, this time it's definitely NOT different! ☺

PLEASE NOTE:

The PERAC Investment Unit welcomes any comments you may have on this report & encourages all boards to contact us at any time for assistance relating to investment activities. Extra copies of this report are available.

Fourth Quarter, 2000 | Total Returns

U.S. Equity Market

INDEX	FOURTH QUARTER RETURN	2000 FULL- YEAR
DOW JONES INDUSTRIAL AVG.	+1.56%	-4.85%
STANDARD & POOR'S 500	-7.82%	-9.10%
NASDAQ COMPOSITE	-32.7%	-39.3%
WILSHIRE 5000 (BROAD MARKET)	-10.3%	-10.9%
RUSSELL MIDCAP	-3.59%	+8.25%
RUSSELL 2000 (SMALL CAP.)	-6.91%	-3.02%

Growth vs. Value

S&P 500 GROWTH	-16.72%	-22.08%
S&P 500 VALUE	+1.63%	+6.08%
RUSSELL MIDCAP GROWTH	-23.25%	-11.75%
RUSSELL MIDCAP VALUE	+9.44%	+19.18%
RUSSELL 2000 GROWTH	-20.20%	-22.43%
RUSSELL 2000 VALUE	+8.11%	+22.83%

Global Equity Markets

M.S.C.I. - E.A.F.E	-2.77%	-13.96%
M.S.C.I. - EMERGING MARKETS	-13.62%	-28.95%

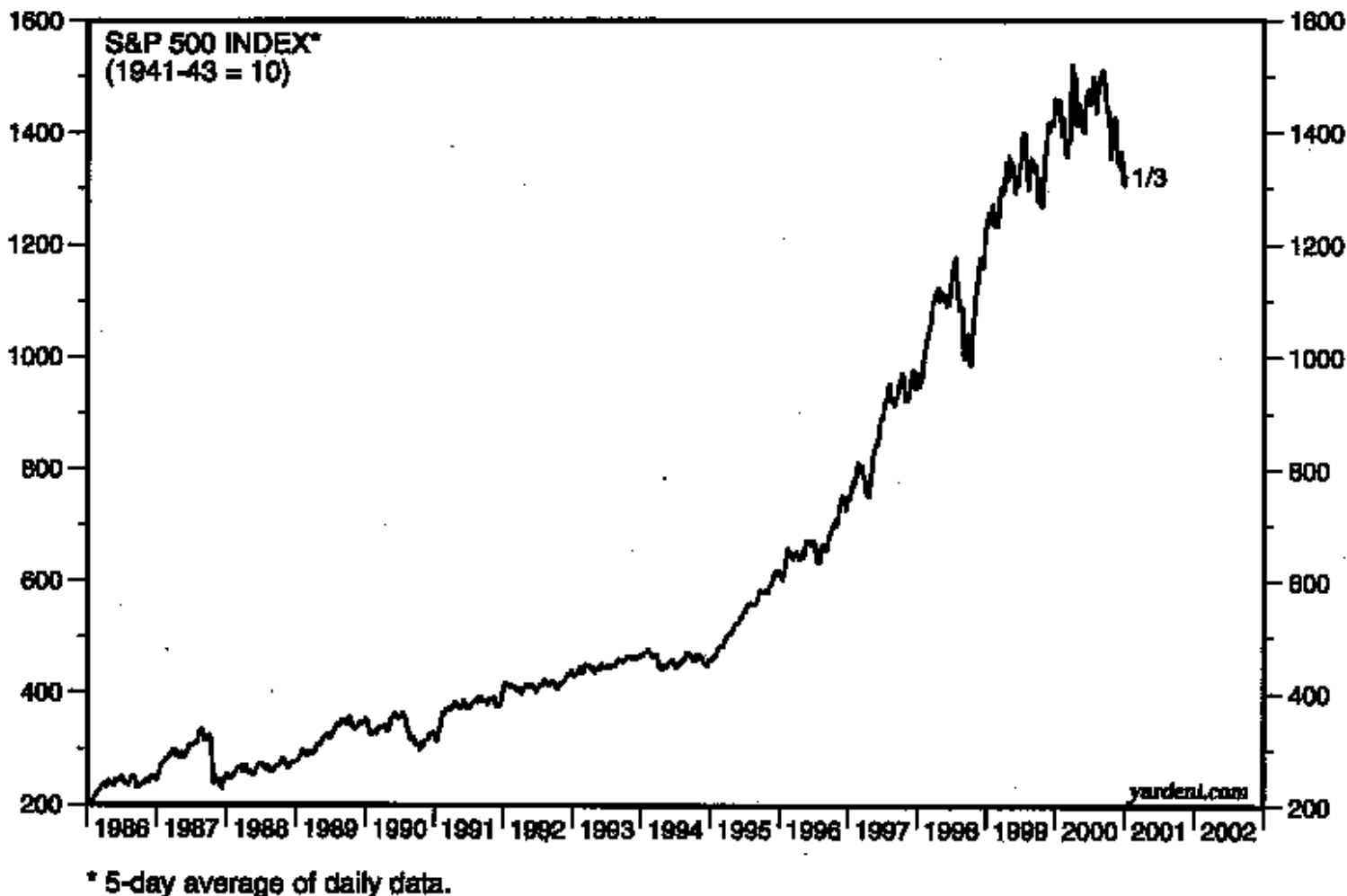
Fixed Income

LEHMAN BROTHERS AGGREGATE INDEX	+4.21%	+11.63%
LEHMAN BROTHERS GOVERNMENT/ CORPORATE INDEX	+4.37%	+11.85%
FIRST BOSTON HIGH-YIELD INDEX	-5.06%	-5.21%

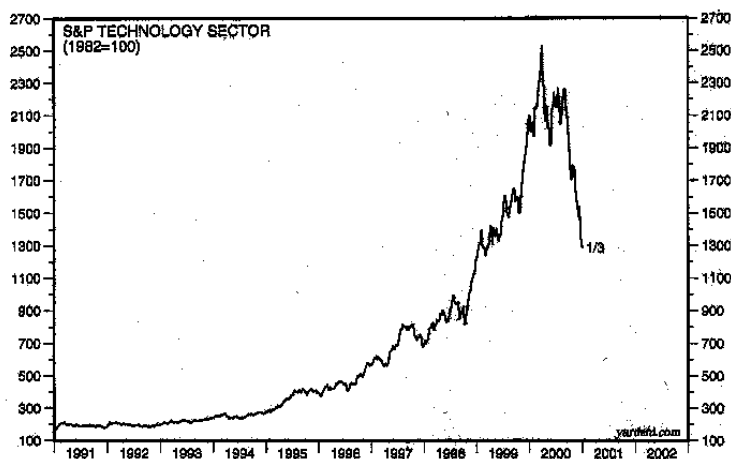
Real Estate

NAREIT - EQUITY REAL ESTATE INVESTMENT TRUSTS	+3.72%	+26.37%
NCREIF PROPERTY INDEX	+2.82(3Q)	+11.65% (TRAILING 12 MONTHS)

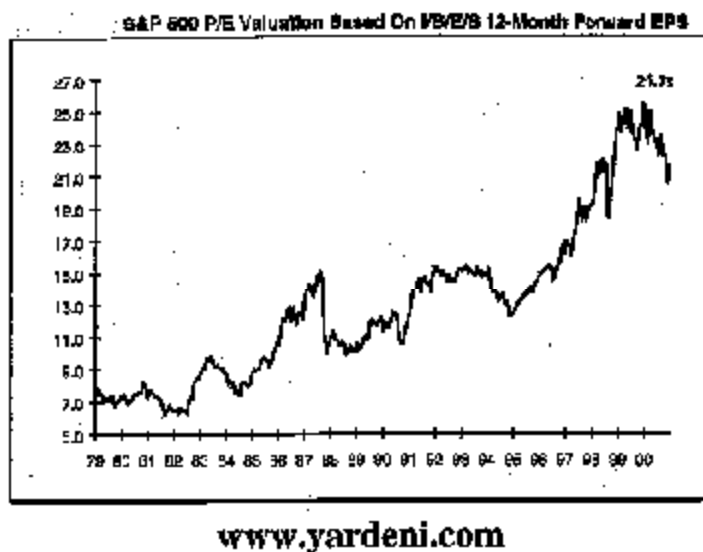
S&P 500: A Long View



The Rise and Fall of Technology Stocks



Equity Valuation: Cheaper, But Still Historically High



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Equity Sector Performance in 2000

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S&P 500 Sectors (2000 Y-T-D percent change)

